Canada. Office of the Auditor General.
Equity assistance to troubled
companies, factors to be considered.

(Discussion paper no. 26)

Office of the Auditor General of Canada

Bureau du vérificateur général du Canada

DISCUSSION PAPER NO. 26

EQUITY ASSISTANCE TO TROUBLED COMPANIES

FACTORS TO BE CONSIDERED

by

John Hitchinson and Paul Ward

June 1984

DISCUSSION PAPER SERIES
DOCUMENTS DE DISCUSSION

ttached paper has been prepared to stimulate ht and discussion regarding our audit ities. The views expressed are those of the r and therefore should not be construed as of the Office.

comments would be appreciated and should be ted to the attention of the author.

ional copies of this paper, or other papers in 'Discussion Paper Series", may be obtained gh the PROFESSIONAL PRACTICES GROUP.

Le document ci-joint vise à stimuler la réflexion et la discussion sur nos activités de vérification. Les opinions exprimées dans ce texte sont celles de l'auteur et, par conséquent, ne lient pas le Bureau.

Vos commentaires seraient appréciés et vous êtes priés de les faire parvenir à l'auteur.

Vous pouvez vous procurer des exemplaires supplémentaires de ce document ou des autres écrits de la série des "Documents de discussion" en vous adressant à la DIRECTION DES MÉTHODES PROFESSIONNELLES.

DISCUSSION PAPER NO. 26

EQUITY ASSISTANCE TO TROUBLED COMPANIES

FACTORS TO BE CONSIDERED

by

John Hitchinson and Paul Ward

June 1984

Introduction

As auditors we would expect the government to have in place procedures for analysing and evaluating a troubled company's current position and planned activities and for monitoring its operations until the government decided to dispose of its equity in the company. The factors and information that we would expect the government to consider are set out below. Under the eight headings is a brief listing of basic considerations; it is not exhaustive or technically definitive. Departments would be expected to develop operationally specific criteria. We would also expect the government to clearly identify and assign responsibility and accountability for all aspects of the administration of equity assistance.

1. Background Information and Documentation
2. Business Plan
3. Review of Business Plan
4. Factors for Evaluating Request for Funds
5. Conditions of Assistance
6. Monitoring
7. Termination of Assistance
8. Evaluation of Assistance Process

1. Background Information and Documentation

- Company history and ownership, including statement of degree of Canadian ownership, and nature of its operations and products.

- Details of corporate and financial structure and relationships with affiliated companies.

- Details of relationships with major customers and major suppliers, including comments on the degree of dependency and the possible effects on these parties if the company were to cease operations.

- Stakeholders' expectations (employees/management, creditors, shareholders, suppliers and customers).

- Statement of Affairs outlining the present assets and liabilities of the company with an estimated realizable value being attributed to the assets. This should include:

  - pro-forma financial statements for the next two years;

  - details of current secured debt and comments on present status of dealings with the company's bankers and other secured lenders;

  - details of any major long-term obligations or commitments such as contracts, agreements, etc.;

  - details of and comments on major lawsuits outstanding, with reference to the possible effect these lawsuits may have on future operations; and

  - detailed comments on the company's prospects of obtaining financing from non-government sources, and efforts made to date to approach these sources.

- Details and status of unsecured creditors.

- Details of any previous government assistance received or applied for from all levels of government.

- Historical financial information to be provided should include:

  - audited financial statements for the past five years, including any management letters or other observations raised by the company's external auditors;

  - most recent interim internal financial statements;

  - sales analysis;

  - production cost analysis;

  - expense analysis by major categories;

  - details of long-term purchase and sales agreements and related contracts;

  - analysis of major long-term lease obligations and commitments for premises, equipment, other assets, etc.;

  - details of and comments on contingent receivables and other assets including potential recoveries from existing lawsuits;

  - details of and comments on contingent liabilities, including potential losses due to existing lawsuits; and

  - analysis of the company's current income tax and sales tax situations with details of outstanding assessments or disputes and amount and age of loss carry forwards for income tax purposes.

- Comparison of the company's key business ratios for the past five years to the applicable published industry ratios to assess how the company is operating in comparison with its competition.

- Details supporting proposed fixed and non-fixed asset acquisitions.

- Any planned changes in payroll indicating the planned changes in number of employees, skill and renumeration level and availability.

- Details of time lost as a result of strikes, absenteeism, etc., over the previous five years or two collective agreements.

2. Business Plan

The company should prepare a detailed business plan for the next five years which addresses the current situation and contains plans for correcting major problems. It should include:

- corporate mission and objectives;

- changes in management structure and controls;

- market forecasts and assumptions for five-year period;

- existing product performance and development of new products and markets;

- manpower requirements;

- research and development, technological development and innovation;

- changes in facilities and manufacturing over next five years;

- capital expenditures over next five years;
- earnings and expenditure forecasts of each division and for the company;
- proposals for dealing with secured and unsecured creditors;
- proposed use of government assistance;
- plans for debt reduction and termination of government assistance; and
- pro-forma financial statements, including cash flow.

3. Review of Business Plan

The plan should be reviewed by experts competent in the various areas covered in the plan. The corporate history in the plan should be checked to ensure that it analyses in detail the specific causes of the company's current problems (general statements, such as "poor economy", are not sufficient).

- The plan should be prepared in such a way as to facilitate assessment of the impact of alternative assumptions.
- The implicit and explicit economic assumptions included in the plan should be reviewed.
- The plan should be adjusted, if necessary, to reflect the appropriate economic assumptions as well as the appropriate industry-specific assumptions.
- Market projections and analysis of the competitive environment should be validated to provide assurance that the forecasts are based on the best information currently available.

- If the projections of costs of production appear to be inconsistent with historical results, these should be reviewed.

- The overall accounting and financial assumptions included in the plan should be reviewed for consistency and to ascertain the basis for projections of such items as levels of inventory, accounts receivable and accounts payable.

- The financing assumptions should be reviewed. Ideally, the plan should be prepared so that the impact of various types and levels of government assistance, including no assistance, can be evaluated.

- The proposed organizational plan should be reviewed to ensure that any managerial deficiencies identified in the history of the firm have been rectified.

- An independent assessment should be made of the effectiveness and ability of management, including directors, as well as their willingness to take the steps necessary to effect a turnaround in the company's operations and restore profitability.

- The business plan should specifically reflect assumptions made by the company with respect to debt reduction and termination of government assistance. Expected cash flows should include when the assistance is expected to be received and when it is to be repaid.

4. Factors for Evaluating Request for Funds

As auditors we would expect to find analysis by the government of the following factors or answers to the following questions:

- the specific benefits that the government hopes to achieve;

- the necessity of this form of assistance to ensure the ongoing viability of the business entity;

- the feasible alternatives, such as a formal proposal to creditors under Part III of the Bankruptcy Act, an informal compromise by existing creditors, new equity from non-governmental sources, and a receivership with a subsequent going concern sale of the assets;

- minimizing the cost to government;

- the potential of the assistance and the conditions under which it is given to address the underlying causes of the company's difficulty whether related to finance, management, labour or product;

- the potential for the company's products to compete successfully in the market place;

- the availability of qualified manpower and the potential for labour stability in the company;

- the short-term and long-term threats to viability;

- the degree of influence and participation in equity, alone or in combination with other support such as loans, guarantees, contributions, etc.;

- the degree of participation in corporation management;

- the conditions for continuing, modifying or terminating support, or disposing of the investment; and

- the method of determining and measuring benefits or adverse consequences that may result.

5. Conditions of Assistance

- The government may wish to set conditions when providing equity assistance. These could include:

  - compromise by existing creditors;

  - concessions from suppliers, customers, management, staff and existing shareholders;

  - proposing membership of one or more government officials or representatives on the Board of Directors;

  - management changes;

  - control over expenditures;

  - dividend restrictions;

  - input into major strategic decisions;

  - adherence to an approved operating plan;

  - a monitoring arrangement; and

  - a right to review assistance in the event of a change in ownership.

6. Monitoring

The government should:

- structure a monthly reporting package to be provided on time by the company to the government;

- review monthly the operations of the company, its financial results and its report to the government on:

  - financial results versus projections,

  - conformity with provisions of assistance agreement,

  - other significant changes in company organization and operations, and

- conduct semi-annually a mandatory formal review of the business plan, supporting information and other appropriate factors that were the basis for the government assistance.

7. Termination of Equity Assistance

- Projections of repayments of the government assistance should be compared regularly to the original projections in the request for funds or the assistance agreement.

- In the event that repayment projections change from the original schedule, the problems should be addressed without delay by the government and the company. This might be done through a formal independent update assessment of the company and its revised business plan.

- If necessary, measures should be negotiated or dictated to the company for improvements and a return to the original repayment schedule, or else a revised acceptable repayment schedule should be agreed between the company and the government.

- In situations where government assistance is provided in the form of share equity, repayment may not be a condition of the assistance. In such circumstances, however, the government should consider what constitutes an adequate rate of return on its investment and how it should monitor operations to ensure that this rate of return is achieved.

8. Evaluation of Assistance Process

- After the termination of an assistance agreement, the process should be evaluated. This should include:

  - an independent review of the government files on the assistance to the particular company, from the initial request for funds to the repayment of the assistance or the company's insolvency; and

  - independent interviews with government officials, senior company management and consultants who participated in the agreement from inception to termination, to streamline and improve the process.

PROS AND CONS OF FEDERAL EQUITY ASSISTANCE

Pros

- Corporation survival assured in short term.
- Improved access to normal financial markets.
- Benefit from return on investment (if viability restored).
- Public perception of having driven a hard bargain (if linked to participation in future profits).
- Ability to exercise more direct influence on policy and management.
- First-hand information on and experience in the management of an industry.

Cons

- Perceived responsibility to all who have dealings with the corporation: suppliers, customers, employees and community at large.
- Perception of government position as a financial guarantor.
- Perceived or actual interference in a competitor's share of the market.
- Forestalling necessary reduction in debt load.
- Lessening creditors' willingness to accept compromise.
- Blurring of objectives in the corporation; for example, economic versus social objectives.
- Increased delay in identifying and correcting problems.
- Requirement for continual monitoring to ensure efficient and effective use of public funds and to protect the investment.
- Tariff response or imposition of countervailing duties or taxes.
- Lack of federal framework for accountability and control of existing owned corporations.
- Potential conflict of interest for public servant who is both a senior member of a government department and a member of the board of directors.
- Difficulty of withdrawal.